Quarterly Economic Update

December 10, 2008

Monetary Policy

By Lance Lachney

At the time of our last meeting, the Federal Reserve had just left short-term interest rates unchanged at the August FOMC meeting. There was one dissenting vote, cast by Dallas Fed President Richard Fisher, who preferred an increase in the target for the federal funds rate. At this point in time, there was roughly a 60% chance of a rate hike by year-end. The Retirement Systems of Alabama stated that it felt the next move by the Federal Reserve was just as likely to be an ease as it was a hike. The reasoning behind this belief was the economic slowdown occurring across the globe, a reluctant consumer, and the inability of lending institutions to extend credit. We felt that for these reasons alone that policymakers would remain on the sidelines for some time.

After much debate and speculation, Treasury Secretary Hank Paulson stepped in to prevent a collapse of Fannie Mae and Freddie Mac in early September. The government seized control of the mortgage-finance companies, essentially rendering the preferred and common stocks of the two companies worthless. The takeovers of Fannie and Freddie had been the biggest step taken during the credit crisis as the two represent over 40% ($5 trillion) of the mortgage market. Within a week, there was a new problem facing the government – the fate of Lehman Brothers. The 160-year old firm was forced to file for bankruptcy after its plan to restructure did not materialize in time. Despite a weekend full of negotiations between the Federal Reserve, the Treasury Department, and leading financial institutions, a viable solution could not be reached. The major sticking point being the reluctance of the government to provide any guaranteed money or backstop in a potential deal. As an aside, Merrill Lynch, fearing this would set off a chain reaction of investment bank failures, agreed to be purchased by Bank of America. On September 16th, the following day, the Fed met at its regularly scheduled meeting, leaving rates unchanged once again. The statement did acknowledge that “strains in financial markets have increased significantly and labor markets have weakened further”. However, the highlight of the day was the nationalization of one of the world’s largest insurers. AIG, on life support due to collateral calls on mortgage-related credit default swaps that it had written, was given an $85 billion lifeline so it could sell assets in an orderly fashion rather than at distressed prices. The Federal Reserve “determined that, in current circumstances, a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance”. The $85 billion loan was a two-year commitment carrying a rate of 3-month Libor +850bps. AIG management was also shown the door.

As these historic events began to unfold, global credit markets came grinding to a halt. Financial institutions around the world began to hoard cash due to risks surrounding counterparties. Several European central banks injected liquidity into money markets and regulators around the globe halted short selling in an attempt to prop up financials' shares. The Fed created an ABCP Money Market Mutual Fund Liquidity Facility, which extends loans to banks to purchase "high quality" asset-backed commercial paper from money market funds. This was done in order to prevent any type of run on money markets. The Federal Reserve also opened currency swap lines with several countries to improve liquidity conditions within the global financial system. During this time Washington Mutual was seized by the FDIC, and JP Morgan gobbled up its deposit base. Washington Mutual was one of the largest providers of option ARMs, and its credit ratings had been slashed in recent weeks as the company estimated another $20 billion in mortgage losses over the next couple of years. Money market rates during this time signaled that banks had all but stopped lending to one another. To make matters worse, despite Chairman Ben Bernanke's warning of "grave threats" to financial markets, the House of Representatives rejected the $700 billion rescue plan offered by the Treasury Department.

Despite putting up a bold front, both sides of Congress ultimately passed the Treasury Department's rescue package, giving Secretary Paulson free reign to disburse $350 billion immediately in a variety of ways. Chairman Ben Bernanke was also extended power in the legislation that will now allow the Fed to pay interest on bank reserves. The fed funds rate is the rate at which reserves are borrowed and lent overnight. The Fed also announced an expansion of the Term Auction Facility to $950 billion. On the morning of October 8, in response to global market weakness, policymakers around the world cut short-term interest rates by 50 basis points in a joint effort. Those bodies participating included the Federal Reserve, the European Central Bank, the Bank of England, the Bank of Canada, the Swiss National Bank, and Sweden's Riksbank. The joint statement read "the recent intensification of the financial crisis has augmented the downside risks to growth and thus has diminished further the upside risks to price stability". In separate actions, rate cuts were enacted in China, South Korea, Taiwan, and Hong Kong. In another effort to help stabilize money markets, the Fed introduced the Money Market Investing Funding Facility, a $540 billion backstop to relieve pressure on money market mutual funds caused by redemptions. At its scheduled meeting in late October, the Federal Reserve lowered the fed funds rate by 50 basis points to 1 percent. It stated that "recent policy actions, including today's rate reduction, coordinated interest-rate cuts by central banks, extraordinary liquidity measures, and official steps to strengthen financial systems, should help over time to improve credit conditions and promote a return to moderate economic growth".

Over the past month, short-term lending markets have moderately loosened up with the 3-month Libor hovering around 2.20%, down considerably from its 4.82% peak in mid-October. The Bank of England has lowered another 250 basis points to 2% after its biggest inflation drop in 11 years. The AIG deal has been restructured, now consisting of a $60 billion loan with better terms, $40 billion in preferred stock, and a $50 billion facility, established to purchase its mortgage securities. Much was revealed in the minutes from the late October FOMC meeting. Policymakers now expect that the economy will contract until the middle of next year, that the unemployment rate will "rise significantly through early 2010", and that "more aggressive easing should reduce the odds of a deflationary outcome". And to think that inflation was the "word of the moment" just months ago. Two weeks ago, the Federal Reserve committed another $800 billion in assistance. It created the Term Asset-Backed Securities Loan Facility, which will lend up to $200 billion to holders of AAA-rated ABS backed by newly originated consumer and small business loans. It will also directly purchase $100 billion in agency debt and up to $500 billion in mortgage-backed securities backed by Fannie Mae, Freddie Mac, and Ginnie Mae. "This action is being taken to reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally." Just yesterday, Chairman Bernanke recognizing he has little room left to alter interest rates, threw out the idea of buying treasury securities outright.

The Federal Reserve's next scheduled meeting is set for December 15th, a two-day event. As of today, there is a 100% probability of a rate cut of 50 basis points with a 50/50 chance of a 75 basis point move. In the past year, Chairman Ben Bernanke has created emergency lending programs that has eclipsed $2 trillion using the Fed's balance sheet to help the economy during one of its worst times since the Great Depression. These programs are considered assets on the Fed's balance sheet that are offset by increases in bank reserves held at the Fed. This growth in the monetary base (reserves) would, under normal circumstances, cause similar growth in the money supply. However, as businesses and consumers are reluctant to let go of cash during this crisis, the money supply has only grown modestly. The tricky part of the equation will be winding down these programs when things stabilize in order to prevent an explosion in the money supply, which could spark inflation. Bernanke himself says that the balance sheet "will eventually have to be brought back to a more sustainable level, however that is an issue for the future. For now, the goal of policy must be to support financial markets and the economy". Bernanke has been successful in letting the genie out of the bottle; it is highly debatable whether he can get her back in.

Fiscal Policy

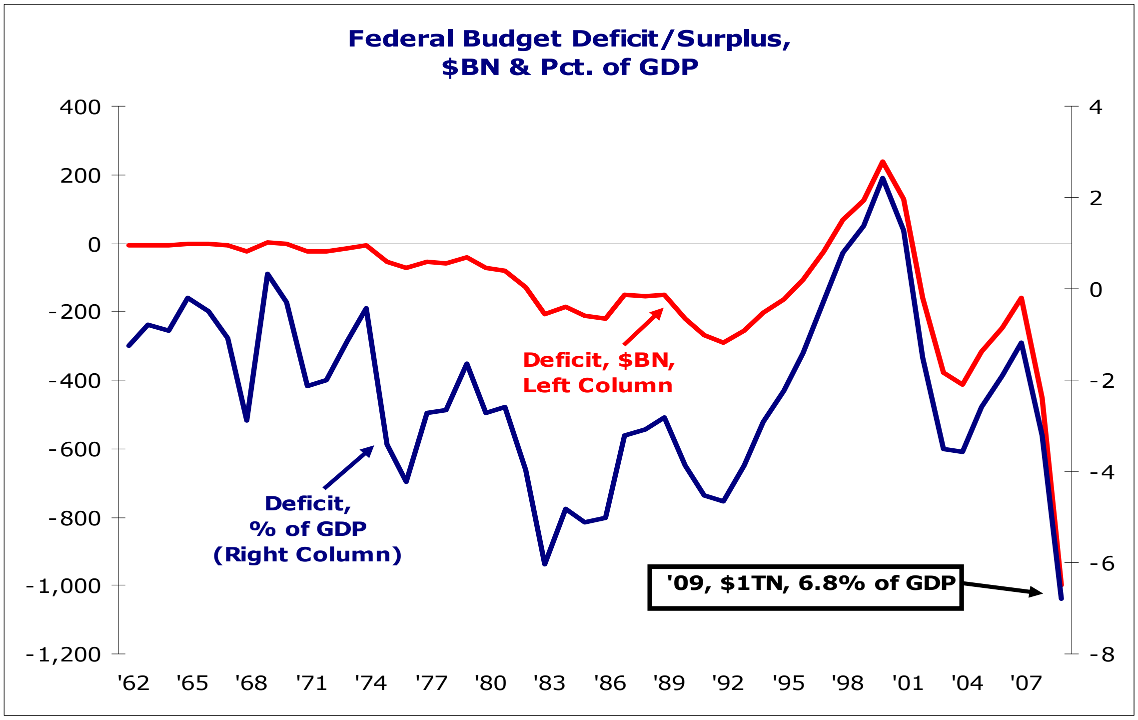
By Adam Rogers

Our nation's fiscal policy has been difficult to pin down lately. This is meant in the sense that what is true one day has rarely been true beyond that day. One day Treasury Secretary Paulson receives $700 billion in rescue funds from Congress, only to change its stated purpose less than a month after it is granted. The next day we are hearing that President-elect Obama is planning for an additional $700 billion in stimulus, up from the original expectation of $100 billion. Despite the fast moving yet difficult to trace parts, one thing we know for certain is there is much to discuss. We'll start with the general data released by the CBO and then dive into the details of all that has transpired in the past few months.

Current Budget

To start Fiscal Year 2009, the U.S. government's budget deficit for October reflected the dual effects of a U.S. recession and the War in Iraq. The monthly deficit jumped to $237.2B, more than four times last year's deficit of $56.8B. October's figure also was more than double consensus projections for a deficit of $99.2B. Many forecasts for the budget deficit during all of this fiscal year are near $700B. If realized, that would swell the deficit to about 5% of GDP following last year's roughly 3.2% and FY07's marginal 1.2%. In fact, these estimates are likely conservative. **We feel the deficit could easily swell to $1 trillion, representing 6.8% of GDP by FY09.** Net revenues during October suffered greatly and fell 7.5% from last year. Higher unemployment took the steam out of individual income tax receipts and they fell 9.7% from last October. Lingering payouts of the Government's "stimulus" checks reduced revenues somewhat. However, the big negative factor would have been that payroll employment, and thus tax receipts, fell roughly 1.0% y/y. Suffering even more were corporate tax receipts which nearly evaporated with huge stated losses. Growth in unemployment and social insurance taxes grew a reduced 3.7%, the least since 2004. U.S. government outlays nearly doubled versus last November, lifted mostly by a jump in the "commerce & housing credit". Defense spending (19% of total outlays) rose an accelerated 17.9%. The gain does not reflect the full cost of the resources devoted to Iraq and Afghanistan since much of the spending would have occurred anyway. Medicare expenditures (12% of outlays) rose by nearly one-half but that followed an October decline. Social security spending (21% of outlays) rose 6% after 6.8% growth last year. Net interest payments increased 4.3% y/y.

The chart on the following page depicts our fiscal situation. As you can see, this chart dates back to 1962 and the current deficit in nominal terms and as a percentage of GDP is the worst it's been in this time frame. While the number may seem staggering, we should also remember that following World War II, the deficit reached 25% of GDP. So, this is not the worst fiscal shape we've ever been in. The current British deficit is already over 8% of GDP, in an economy dominated by financial services. So in perspective, our budget is not pretty, but it's been worse.



Source: Strategas Group

Government Actions (Bailouts and Facilities)

It really is amazing that not a week has gone by for the past few months without the Federal Government, in some form or fashion, pledging enormous amounts of money for a myriad of purposes. To date, the government has pledged over $7.7 trillion in order to "ease credit". As of this writing, that number is already out of date. On November 25, the Federal Reserve committed up to $800 billion more. This announcement stated that the central bank will purchase as much as $600 billion of debt issued by GSEs (Fannie Mae/Freddie Mac) and will also set up a $200 billion program to support consumer and small-business loans. The stated purpose of this particular action is basically to bring down mortgage rates. Because, while the Fed had lowered its target rate all the way down to 1%, mortgage rates have not followed. The 30-year fixed mortgage rate has continued to bounce between 5 and 6% as it has for the past year. So in total, that's **$8.5 trillion in pledges.** That is over half the value of every produced good in the U.S. last year. To put it in an even more acute perspective, this amount of money is equivalent to **$27,200 for every man woman and child in the country.** According to Bloomberg, it is nine times what the U.S. has spent so far on wars in Iraq and Afghanistan. It could pay off more than half of the country's mortgages. However, we should remember that not all that is pledged will necessarily be used. The following is a synopsis of all government action taken to date since the credit crisis took hold, broken out by the sponsoring government entity. It does not include the $300 billion bailout of Citigroup nor the $800 billion just committed by the Fed.

Federal Reserve		
Net Portfolio Commercial Paper Funding	$1.8 trillion	$270.9 billion
Term Auction Facility	$900 billion	$415.3 billion
Other Assets	$601.9 billion	$601.9 billion
MMIF	$540 billion	$0
Term Securities Lending	$250 billion	$190.2 billion
Other Credit Extensions	$122.8 billion	$122.8 billion
Primary Credit Discount	$92.6 billion	$92.6 billion
ABCP Liguidity	$61.9 billion	$61.9 billion
Primary dealer and others	$46.6 billion	$46.6 billion
Net Portfolio Maiden Lane	$28.8 billion	$26.9 billion
Securities Lending Overnight	$10.3 billion	$10.3 billion
Secondary Credit	$118 million	$118 million
FDIC		
FDIC liquidity guarantees	$1.4 trillion	$0
Loan guarantee to lending arm of Genereal Electric	$139 billion	$139 billion
Treasury Department		
Troubled Asset Relief Program (TARP)	$700 billion	$350 billion
Fannie Mae/Freddie Mac	$200 billion	$0
Stimulus Package	$168 billion	$168 billion
Treasury Exchange Stabilization Fund	$50 billion	$50 billion
Tax breaks for banks	$29 billion	$29 billion
FHA		
Hope for Homeowners	$300 billion	$300 billion

2009 Budget and Stimulus

There is a developing consensus that given the stress of the economy and financial system, President-elect Obama will forego scrapping the Bush Tax Cuts, allowing them to expire at the end of 2010. Recently, a number of key members of Congress discussed the upcoming stimulus package with some, most notable Sen. Schumer, proposing a $500 - $700 billion package to be passed before Obama takes office and ready for his signature on Inauguration Day. At this point, speculation is all we have and the possible range of the stimulus could be as low as $300 billion to as high as $700 billion. The focus of the package will likely be on infrastructure spending and aid to state governments. Currently, infrastructure spending and aid to states only amounts to $100 billion of stimulus, so we are watching to see if a refundable tax credit for payroll taxes and defined benefit pension relief are included. After that, there will likely be a series of smaller initiatives which will include funding for upgrades to transmission lines and the existing power grid as a way to set the infrastructure for future alternative energy initiatives. Perhaps most important, policymakers continue to push for a large healthcare reform package (est. cost $100 billion per year) to be included in the budget (to avoid a filibuster in the Senate). The additional spending plans coupled with a large stimulus package and the already deep deficit set the stage for higher taxes down the road.

2009 BUDGET TIMELINE

- January 20, 2009 - Obama sworn in. Most likely will sign a large stimulus package into law.
- One week later – Congressional Budget Office releases large budget deficit numbers. Budget deficit current stands at $635bn (4.4 pct of GDP).
- Second week of February – Obama has to submit his budget for FY '10
- First week of March – Congress begins consideration of FY '10 budget
- End of March/Early April – Congress finalizes budget – do they leave room for tax increases under the Reconciliation process? If so then only 51 Senate votes will be needed for tax increases. Also watching to see if a healthcare package is included which raises the probability of tax increases.
- Mid-April – Committees begin work on structuring the tax increases.
- Memorial Day Through Summer – Congress finishes work on tax increase

Source: Strategas Group, LLC.

State Budgets and Aid Proposals

State governments are forecasting more than $100 billion in budget gaps over the next two fiscal years and would call for major federal spending to help with the coming shortfall. The following is an article from the Wall Street Journal which summarizes a meeting in early December between the nation's governors and President-elect Obama and his staff.

> WASHINGTON -- The nation's governors urged Congress to pass an economic-stimulus package for states, warning that their collective budget shortfall could rise to $140 billion by mid-2010.
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> Pennsylvania Gov. Ed Rendell, who heads the National Governors Association, and Vermont Gov. James Douglas met with congressional leaders Monday to give them a preview of the association's proposal, which seeks at least $126 billion of federal funding to help states pay for rebuilding infrastructure, expanding social programs and extending unemployment benefits.
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> On Tuesday, a group of about 40 governors is scheduled to meet with President-elect Barack Obama in Philadelphia to discuss the proposal. Mr. Obama has repeatedly pledged to help states cope with the economic downturn.
>
> The governors said the plan, if implemented, would do far more to spur the economy than other federal stimulus efforts, such as the $700 billion financial-industry rescue package approved by Congress in October. "Not any of that help has produced one new job," Gov. Rendell said.
>
> House Speaker Nancy Pelosi, who was among the lawmakers meeting with the two governors Monday, has voiced support for a state stimulus package that includes money to jump-start infrastructure projects, though the California Democrat hasn't settled on a specific amount. Mr. Obama has asked Congress to prepare a stimulus package by the day he takes office.
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> After enjoying years of flush budgets, many states have been forced to prune spending because of falling sales-tax receipts and other revenue. The state of New York, which depends on Wall Street for about 20% of its revenue, said it is facing a $2 billion budget shortfall by March. In California, Gov. Arnold Schwarzenegger declared a fiscal emergency Monday and called lawmakers into a special session to address a $11.2 billion shortfall. The state's revenue gap is expected to hit $28 billion over the next 19 months, and without quick action, the state said it is likely to run out of cash in February.
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> Though some energy-producing states enjoyed a boom when oil prices surged this year, Gov. Rendell said 43 states face a looming deficit within the year. States collectively have trimmed $53 billion so far from their fiscal 2008 and 2009 budgets, the National Conference of State Legislatures said.
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> Unlike the federal government, states are generally prohibited by their constitutions from running deficits.
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> The governors association package, which seeks about $60 billion to finance infrastructure projects, is designed to square with one of Mr. Obama's core campaign proposals.
>
> Gov. Rendell said states have more than $136 billion of infrastructure projects that could be started immediately with federal funding. More than 70% of those involve transportation infrastructure, but he said states also need money for public-safety improvements, port expansions and renewable-energy projects. He compared the scale of the proposed stimulus to President Dwight Eisenhower's interstate-highway project of the 1950s.
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> Governors and state legislatures also are seeking a minimum of $40 billion to cover additional costs for Medicaid, the country's health program for lower-income families, over two years; a further extension of unemployment benefits that would cost an estimated $2 billion; and $3.5 billion of college grant money to cover an expected national shortfall.
>
> The federal-relief request from states isn't unprecedented. In 2003, Congress gave states about $20 billion of Medicaid assistance to cover shortfalls stemming from an economic downturn that began in late-2001.
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> Gov. Rendell said he doesn't expect Congress and Mr. Obama to approve all that the governors are requesting. He said he also doesn't expect President George W. Bush to provide much assistance to states before he leaves office in January, though congressional leaders continue to push for that.

With politics and the economy foremost on the minds of so many, it is no wonder that “Bailout” took home honors as Merriam-Webster’s Word of the Year for 2008. Socialism came in third on that list. Many have likened our government’s response to the credit crisis as throwing a bunch of spaghetti against a wall and seeing what sticks. While a humorous analogy, it will be impossible to tell if the government has gone too far or not far enough until the economy stabilizes. Inflation will provide the answer. Too far, and inflation could become a big problem.

It is rare for fiscal policy to be a hot topic. There is usually little to talk about other than tax receipt data and expenditures, which can get fairly dry. But with traditional monetary policy losing effectiveness, the federal government has stepped up in a very big way. The effectiveness of the federal government’s policies and likely unforeseen consequences will show themselves with time.

Economic Outlook

By Allan Carr

To put it mildly, the economic data since our last update has not been very good. The consumer is getting hit from everywhere. Corporate spending is slowing. Unemployment is going to keep rising. The combination of a global slowdown and the dollar strengthening will continue to hurt exports. On the bright side is the continued decline in energy and gas prices, stimulus packages, and mortgage rates falling to three year lows. While the news is not likely to get better in the near term, we look at what is needed for the US economy to resume growing, hopefully by the end of 2009.

It's Official: We're in a Recession

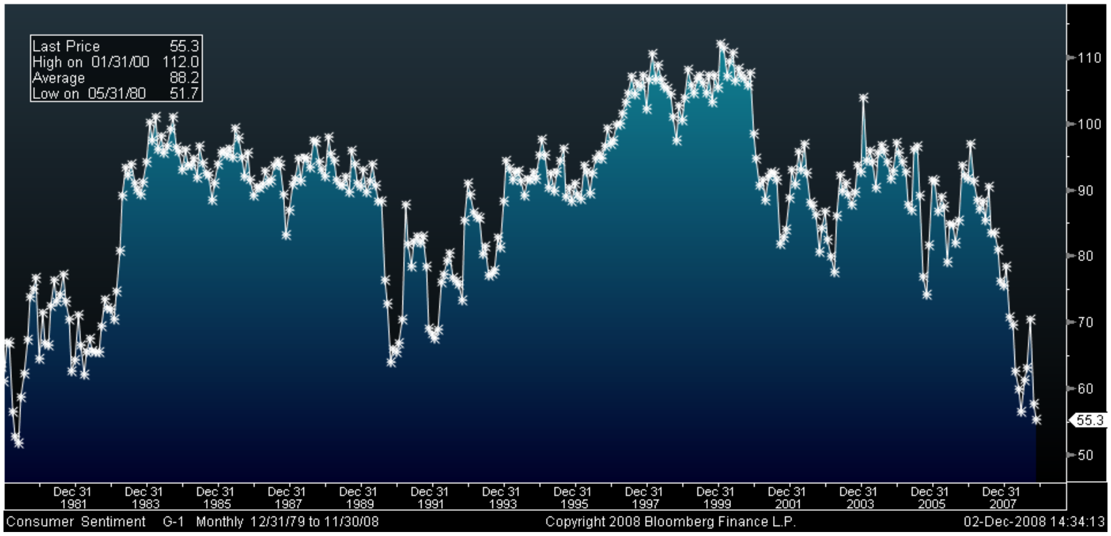
On December 1, the National Bureau of Economic Research(NBER) told us that the US entered a recession in December of last year. While the loose definition of a recession is often said to be two consecutive quarters of negative GDP growth, the NBER defines it as "a significant decline in economic activity spread across the economy lasting more than a few months, normally visible in real GDP growth, real personal income, employment (non-farm payrolls), industrial production, and wholesale-retail sales."

According to the NBER, the biggest factor in pinning the start date was the nearly 1.2 million job losses this year. We will get November payroll numbers just after this update goes to print, and the consensus is for another 330,000 jobs lost, bringing the 2008 total to over 1.5 million jobs lost. A payroll number in line with estimates will result in a 6.8% unemployment rate; the highest it's been since 1993 as seen in the chart below.

With no clear signs that the worst is over it is likely that this recession will be the longest in duration in the post-war era. Employment continues to be the linchpin for the economy, in our opinion. And given a challenging growth outlook heading into 2009, it appears it will not get better anytime soon.

Consumer Sentiment/Consumer Spending

Consumer confidence continues to deteriorate and is hovering near all time lows. The chart below shows the University of Michigan Consumer Sentiment Survey for the last 30 years.



As you can see, sentiment has fallen fast during this credit crunch and is the lowest it's been since the 1980 recession.

Given the lousy confidence and sentiment numbers, it's not surprising consumer spending has been abysmal as well. On November 26 the government reported that personal consumer expenditures were down for a record fourth consecutive month and had the worst quarterly decline since September 2001. According to Dave Rosenberg at Merrill Lynch, "people are cutting back on discretionary spending at an alarming rate over the past four months: Motor vehicles down -40% at an annual rate, airlines (-20%)…hotels (-18%)….clothing (-14%)…toys(-11%). Even toiletries and groceries(-6%) have declined…The only areas that have posted increases in spending over this unprecedented four-month period have been pharmaceuticals (+7%), telecom services (+3%), medical care services (+5%) and mass transit (26%) – all other forms of transportation, from rail to bus to air have collapsed at a19% annual rate."

Growth/GDP

After growing 26 out of 27 quarters following 9/11, the US economy posted negative quarter over quarter GDP growth of -0.5% in the third quarter. The projection for fourth quarter is for -5% growth, and that might prove to be optimistic. If GDP comes in down 5% or lower, it will be the worst quarter dating back to the early 80's. Looking across economist estimates, it doesn't appear growth will resume until third quarter 2009 at the earliest, and the end keeps being pushed out.

We can better understand the somber outlook for GDP growth by breaking it down. The four main components of GDP are consumption, investment, net exports, and government spending. At around 70%, consumption is by far the largest component and is broken down into durable and non-durable goods, as well as services. With unemployment rising, confidence falling, and house prices declining, it is hard to see this component snapping back quickly.

The investment component includes the building of residential homes and spending by businesses on things such as plants, computers, software, etc. With a glut of homes sitting on the market, demand for new construction does not look promising near term. With companies looking to cut costs and many of them dependent on financing for projects, business spending does not look great either.

Net exports had been a source of growth during the long slide in the dollar. However, with the global picture deteriorating in recent months, the global flight to quality trade has caused a strong rally in the dollar. The chart below shows the DXY Index performance over the last twenty years. The DXY Index is a custom index of the US dollar versus six major currencies: the Euro, the Japanese Yen, British Pound, Canadian Dollar, Swedish Krona, and Swiss Franc.

After a long six year plus slide, the dollar has rallied over 20% since bottoming in mid-July. Should this trend continue, global demand for US products and services would become even less attractive, further dampening GDP growth.

The last component is government spending. We don't need to go into much detail on this one as the monetary and fiscal updates are chock full of stimulus packages, bailouts, and new regime infrastructure plans. Government spending will remain robust and provide a boost to growth.

What Inflation?

Just two quarters ago in our May meeting, a common risk mentioned in just about every section was inflation. Rising commodity prices, namely energy, were going to put the consumer under, putting Bernanke in a bind of needing to balance fears of the consumer faltering with fears of inflation. In roughly six months time, the talk has now flipped 180 degrees to deflation. The latest Consumer Price Index statistics showed prices falling, with the core level showing it's first month-over-month decline in its roughly twenty five year history.

We are happy to cross inflationary fears off the list and think energy prices staying low are important to a consumer recovery. So while we do not want to dismiss deflation as a risk, we think deflationary fears are premature and there are more pressing concerns currently.

Outlook

While the outlook for the economy looks grim, it is important to try and figure out what it will take to get the economy to stabilize and then return to growth. On this subject, we defer to noted economists at ISI, Nancy Lazar and Ed Hyman. While they do not seem too optimistic that we will return to positive GDP growth until third quarter of 2009, they do lay out the things they believe are necessary for it to happen. On November 25 they laid out 10 things:

1) Massive fiscal stimulus around the world
2) Gasoline prices stay around $2.00
3) Significant further declines in global short rates
4) The Fed's balance sheet expands to $3 trillion and M2 growth of 10%.
5) Mortgage rates decline to 5.00%
6) Streamline mortgages in favor of homeowners
7) LIBOR declines to 1.25% and financial institutions are recapitalized.
8) Financial markets improve
9) Autos, houses and inventories bottom in nine months
10) House prices drop almost -30% from their peak in nine months (implies an additional 10% drop from the 20% we've already seen).

Looking at their list, we have seen some progress on several of the ones they mentioned in the short time since being published. Fiscal stimulus plans announced around the globe continue to be announced, from China to the UK to the US. Gasoline prices continue to come down. Following the TALF announcement that the Fed would be buying MBS, mortgage rates fell to their lowest level in three years, down almost a full percentage point from late October. On the heels of the drop in mortgage rates, the Mortgage Bankers Association reported on December 2 that mortgage applications more than doubled from the prior week and refinances had the biggest weekly gain on record, up 203%. On December 3 the Wall Street Journal reported a possible plan by the Treasury to stimulate the housing market with 4.5% mortgages for certain borrowers, most likely limited to new home buyers. Bernanke spoke on December 4 on possible steps taken to refinance borrowers to more favorable terms to help stem foreclosures. Hopefully progress continues to be made.

Interest Rates and Fixed Income Strategy

By Julie Barranco

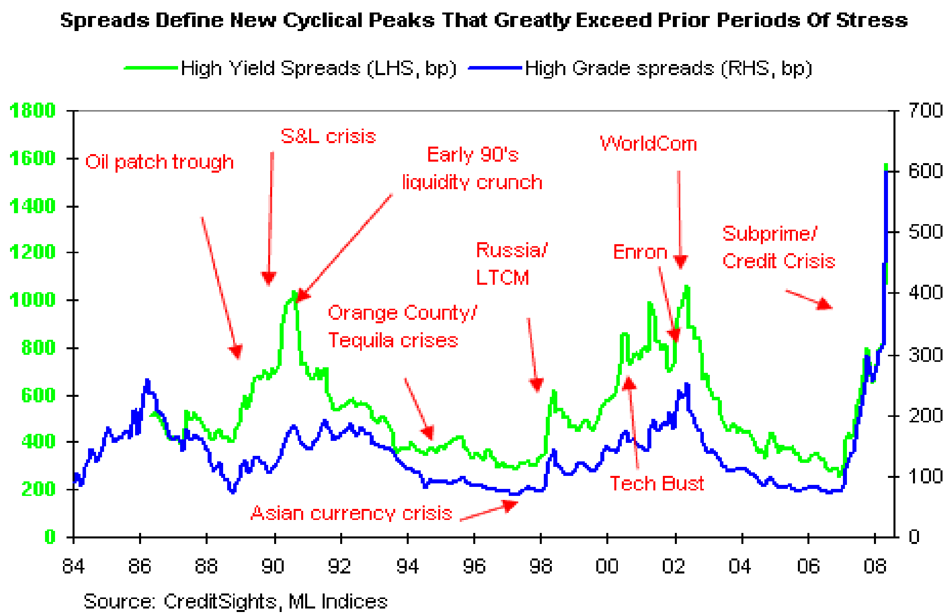
At our last meeting in August, we spoke of the continued volatility in the bond market. Sentiment had begun to sour again and economic issues including further job losses, inflationary food and energy price increases, a weak housing market and a slowdown in consumer spending all continued to threaten the fundamental strength of the market. Spreads were widening in agency and mortgage sectors again due to worries about the viability of the GSE's, and corporate spreads had begun to widen as well, particularly in the financial sector as more write-downs were announced. We were just beginning what would be an unprecedented time.

In September, the crisis of confidence took a decided turn for the worse. In rapid succession we saw the U.S government takeover of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers, the sale of Merrill Lynch to Banc of America, the U.S. government bailout of AIG, the reorganization of Goldman Sachs and Morgan Stanley into bank holding companies, the proposal of the $700 billion TARP program by the U.S. government and the nationalization of several European banks. Money market funds were also in the spotlight at this time; prime money market funds experienced a flood of redemptions as investors sought a higher degree of safety in Treasury funds. This led to a significant decline in demand for commercial paper, which in turn led the issuers of commercial paper to hoard their cash. During September, the yield on one-month Treasury bills approached 0% as risk avoidance became the sole priority.

In this environment of fear, spreads ballooned and liquidity all but disappeared in most markets. Even the normally stable short term borrowing rates between banks of the highest quality, represented by the spreads between LIBOR and Fed Funds, rose dramatically. In the final two weeks of the quarter, the government proposed the Emergency Economic Stabilization Act of 2008. This program would have the U.S. government buy the illiquid and hard to value assets of financial institutions, allowing them to thus be removed from their balance sheets. Capital positions would then be clarified and uncertainty among market participants reduced. Additionally, replacing these low quality assets with cash would presumably make it easier for these financial institutions to lend.

As the quarter ended, the financial markets seemed more troubled than ever. The flight to quality had pushed short term Treasury bill yields under 1%. With credit markets all but frozen, corporate bonds suffered their worst quarter ever, pushing spreads on investment grade debt out to roughly 440 basis points and high yield bonds out to 1020 basis points over comparable maturity Treasuries. Agency and mortgage pass through securities unperformed for the quarter as well, but not to the same degree as credit.

As we entered October, news did not improve. Economic data releases were uniformly weak and indicated that the downturn in economic activity had intensified. Real GDP and personal consumption expenditures declined, the labor market remained weak with continuing claims for unemployment rising further and manufacturing data further decelerated. On October 8th, the Fed cut rates by 50 basis points in a coordinated effort with five other central banks; this action was followed by an additional 50 basis point cut at its scheduled meeting on October 29th in an attempt to help ease the credit crisis. Over the course of the month the Treasury curve steepened as the short end rallied and yields declined, while the longer end saw yields rise slightly. Agency and mortgage backed securities underperformed versus Treasuries, but the corporate sector was the big loser for the month yet again. Investment grade spreads ended the month at 606 basis points over comparable maturity Treasuries while high yield ended at 1617 basis points over Treasuries. The chart below depicts investment grade and high yield spread movements since 1984:



During September and October spreads across all credit sectors rose dramatically as the funding markets froze, pushing the level of stress being experienced in the market beyond anything seen historically. This led to further action by central banks – capital injections into banks and asset guarantee programs – aimed at easing credit market conditions. Despite these measures, the markets remained under stress from ongoing deleveraging and impaired funding markets. October did see the corporate new issue market start to open up again. The issuers that came had to pay large concessions to get deals done, but given these discounts, the deals were well received and tightened significantly in the secondary markets.

In early November the story did not initially change much. Treasury yields continued their move downward while spreads across all sectors, most notably the agency sector, continued to widen. With talk of the new government guaranteed bank debt issuance coming soon, questions about the GSE's debt and its ranking as well as valuation versus this new debt came into play. Also during this time, the viability of Citigroup came into question once again. Despite the recent capital injection under the TARP program, investors still had doubts about the company's future. Citigroup's stock price declined severely and the credit spread on their debt widened significantly. The government ultimately stepped in to help stem the tide and avoid further systemic risk to the financial system. This bailout included a capital injection of $20 billion and the government guaranteeing losses on up to $306 billion in risky assets. Around this same time the Federal Reserve announced a new facility, the Term Asset-Backed Loan Facility that would lend up to $200 billion to holders of AAA-rated asset backed securities. Concurrent with this announcement, the Fed also said that it would buy up to $100 billion in GSE debt and up to $500 billion in GSE-backed mortgage securities. The financial market reaction to all of these events was very positive and credit spreads as well as agency spreads tightened accordingly. The chart below highlights the significant moves we have seen just in 5-year agency spreads over the past few months:

Source: Bloomberg

Agency spreads had widened out to historical highs by mid-November with the 5 year spread hitting 160 basis points. When the Fed announced their direct purchase program the following week, agency spreads rebounded dramatically and now yields about 88 basis points over Treasuries.

With these issues at hand and limited liquidity continuing in many sectors, purchase and sale activity has been somewhat muted. We have continued to add selectively to corporates by participating in some of the primary market issues and taking advantage of the large spread concessions versus secondary issues. Issues added were large, higher quality names in the utility and industrial sectors. Most of our purchases have been in the short to intermediate part of the curve so as to keep duration basically neutral within the corporate sector.

We were not particularly active in the agency portfolio during the quarter. With all of headline risk that has been surrounding Fannie Mae and Freddie Mac and the resulting volatility in spreads within this sector, we did not feel it prudent to increase our weighting here significantly. However, we did purchase a couple of attractive issues during pullbacks in this sector. With the Fed buying GSE debt directly now, we expect to see continued spread improvement and less volatility within this sector in the coming months.

We have continued to selectively add some agency mortgage backed security exposure to the portfolio. Liquidity problems within the financial sector and increased volatility in the marketplace have continued to affect this sector. Spreads in this sector hit 20 year wides in Mid-March and have been yielding significantly more than agency notes; in the October/November time period, these wides were tested yet again. We still think there is definite value in some of the more seasoned issues with loans that originated before the peak of the housing bubble; recently issued pools with new collateral can be attractive as well due to the higher credit standards now being employed. As we can find these types of issues that are geographically diversified and have a good payment history, we will continue to add to this sector as we feel spreads still have plenty of room to tighten and this sector will perform well as the financial sector works to normalize.

Domestic Equity Strategy

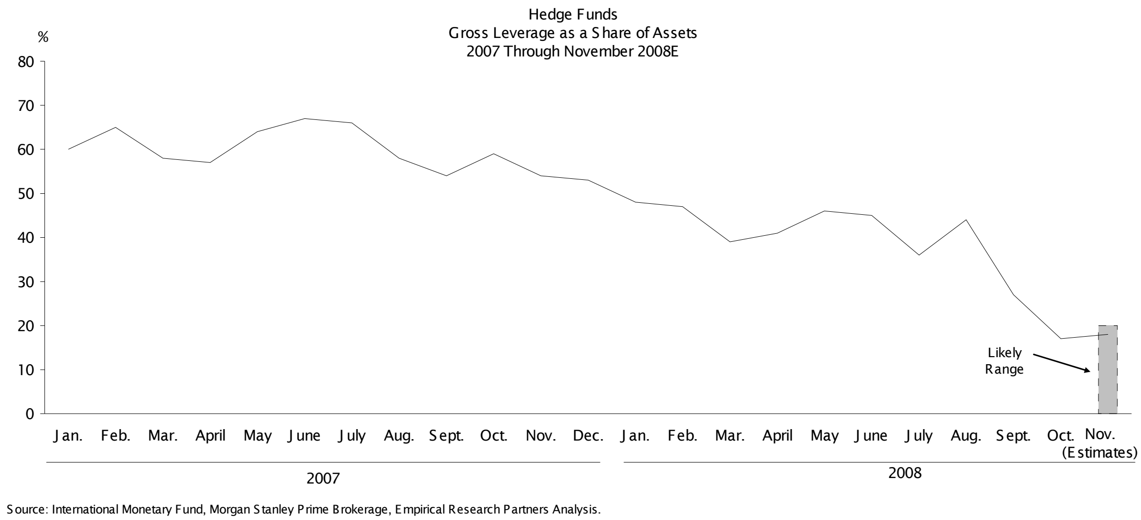
By Marc Green

In the last economic update, I commented that we possibly could see some faint light at the end of the tunnel. That light turned out to be a freight train that ran over the stock market. Trying to pin down what is going on in the market on a day to day basis has been unrewarding to say the least. Looking at nearly all sentiment measures, it looks like investors have thrown in the towel. Yet, when you think the market is completely oversold, it gaps down again. Perhaps the excessive leverage and illiquidity the money management industry has pumped into the system is going to take much longer to unwind than we had hoped. Calendar year-to-date the S&P 500 is down over 42%, as shown by the chart below.

Chart 1

Yes, the economy has moved into a steep recession, and earnings are going to take a big hit. But much of the damage that has been done has to do with leverage. As investors and consumers and businesses have started to hoard cash, the money has to come from somewhere. Obviously much of it is coming out of the stock market. Over $72 billion was withdrawn from equity mutual funds in October alone, which is a record. October was the fifth month in a row of outflows, and November is sure to follow suit when those numbers are released. Hedge funds are also seeing a call on their capital as well. 2006 and 2007 were the biggest inflow years for hedge funds, as wealthy individuals and institutional investors jumped on board the absolute return strategies. Now, we are coming full circle as investors are learning that many hedge funds have returns that are highly correlated with stocks. Redemptions at hedge funds are running rampant right now and the problem is that most use a high degree of leverage. Unwinding those trades exacerbates the pressure on the markets. The following chart shows how leverage used by hedge funds has declined by roughly two-thirds over the course of the year.

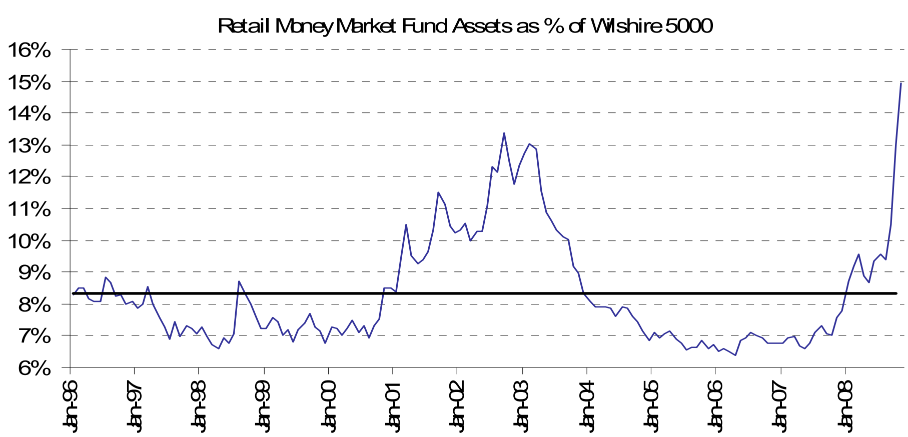
Chart 2



Hopefully, we are getting to the end of the road as far as redemptions are concerned.

As the equity mutual funds and hedge funds are being depleted, money market funds have exploded to the upside. The following chart shows how risk aversion has become in vogue in recent months.

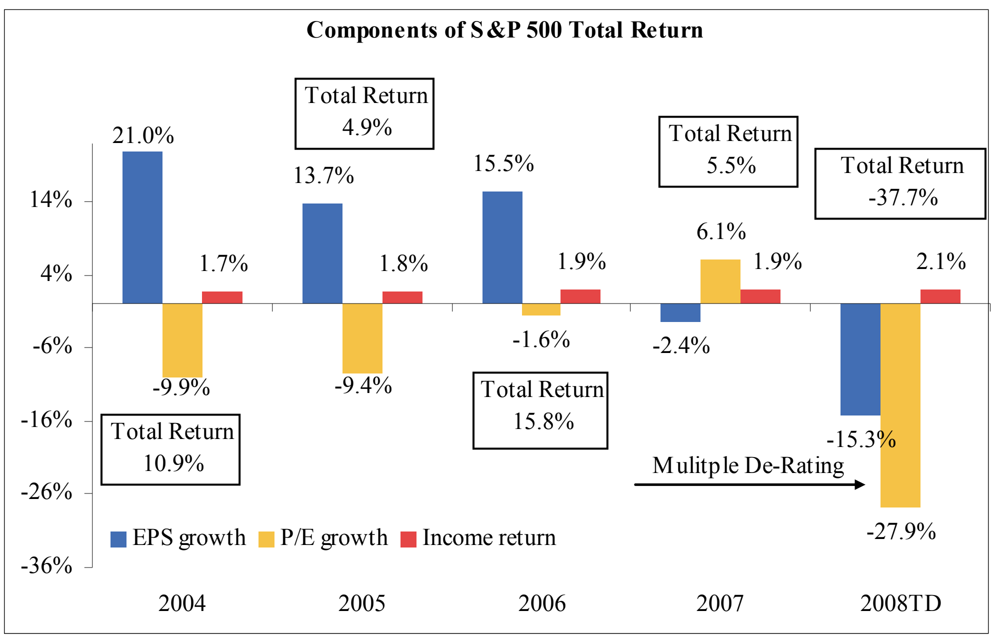
Chart 3



It is hard to say how the current situation improves, but it is definitely fair to say it is well recognized. Policy makers such as those at the ECB who continued to fear inflation up until a few short weeks ago have finally capitulated. They have now cut short term rates from 4.25% to 2.50% in less than 2 months time. From a policy maker standpoint, the intervention we are seeing globally is unprecedented. The list of countries cutting rates is long and growing daily. Considering the number and size of policy missteps made in the past year, we definitely feel that those in power are going to err on the side of over easing vs. taking a wait and see approach. The big question is will all this added liquidity loosen up the credit markets and get banks lending again. We think that it will. To begin, many of the large institutions have been backstopped by the Federal Reserve, and have received equity infusions to shore up their capital base. They have been able to sell impaired assets to the Fed. Now there is a plan to lower mortgage rates by the Fed backstopping Freddie and Fannie. The details have not been announced, but the mortgage market has already priced in lower rates on the news. We believe this is getting to the heart of the issue, mainly addressing the affordability issue on housing.

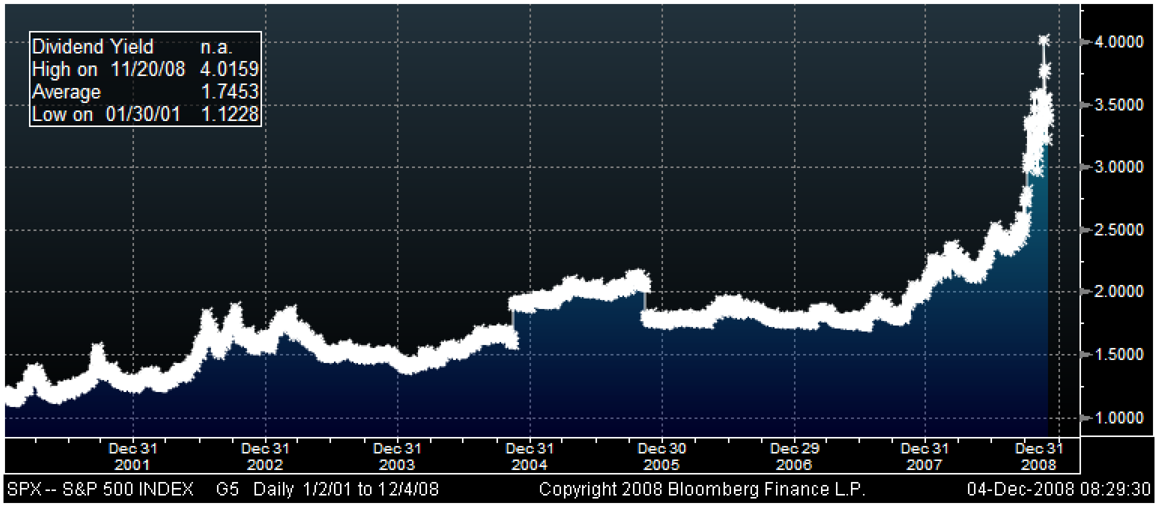
One aspect of the current market malaise is that there has been nowhere to hide. Not a single industry group in the entire S & P 500 is up year-to-date. In fact, they are all down double digits. Including all liquid asset classes, the only place to have made decent money has been in Treasuries. To sum up what has happened in stocks this year, the following chart gives a good breakdown of the return components.

Chart 4



As you can see, earnings declined more than 15% year-over-year, the market multiple was off nearly 28%, and dividends thus far have returned a little over 2%. Interestingly, the market looks good from a dividend yield perspective for the first time in awhile. In fact, the yield on stocks is now 90 basis points over the yield in 10 year U.S. treasury securities. The chart below shows the S & P 500 dividend yield since 2000.

Chart 5



The recent volatility has caused much hesitance on our part as well. Luckily, we are not exposed to any leveraged products such as portable alpha, enhanced indexes, etc, so we have not been involved in forced liquidations. We have not reallocated any new money to the stock market over the past year either. Our weighting in domestic equities coming into fiscal 2008 was 47% and closed out the year at 42%. We are hopeful that the crisis of confidence that we have been living through is drawing to a close.

International Equity Strategy

By Steve Lambdin

It seems like our worst fears came to fruition during the third quarter of 2008. The continued credit market meltdown has pushed most developed regions of the world into recessionary territory with a vengeance. As a result, global equity markets continued to spiral downward during the quarter and have maintained this direction midway through the fourth quarter. Liquidity concerns spread around the globe during the quarter as most credit markets remained in a “functionally seized” mode and central banks have been forced to inject tremendous levels of stimulus to keep the banking sector operating. Business activity continues to erode as this has pushed many regions into a recession. Housing continues to remain in a continued downward spiral, consumers are looking to save more, business inventories are building, and corporate earnings are under severe distress. Simply put, this is the most severe global financial problem since the early 1930’s. The duration of this downturn is anybody’s guess at this point, but we feel the damage we have seen done in an incredibly short period of time will take much longer to fix. With this in mind, we feel global equities will have a hard time performing well until some measure of light is seen at the end of the tunnel. The U.S. Dollar continued to strengthen during the quarter as global deleveraging continued to take place. On a positive note, energy prices have fallen quite dramatically as have other commodities. At this point, we see little to push equity markets higher until investors become more comfortable with what lies ahead in the global economy and the financial sector, even though valuations in many regions of the world are near record lows.

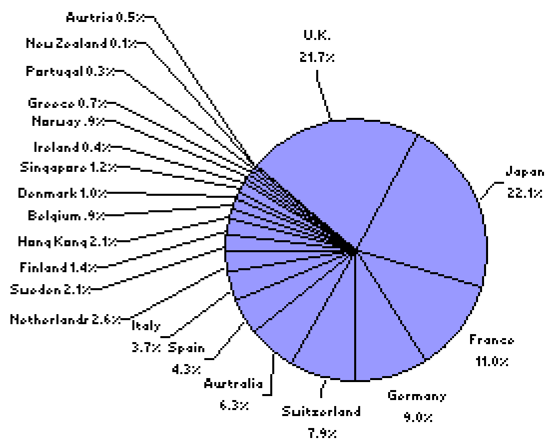
The MSCI EAFE Index (net dividend) returned -20.6% during the quarter vs. -8.4% for the S&P 500 Index. Emerging market returns were even lower than these. Significant appreciation of the U.S. Dollar during the quarter as well as generally weaker local market performance vs. U.S. equities were the main reasons for this underperformance. Within the MSCI EAFE Index, the Asian region slightly outperformed the European region, as many Japanese financials fared a bit better than their U.S. and European counterparts. The best performing countries were Switzerland (-13.2%), Spain (-17.2%), and Japan (-18.3%), while Ireland (-42.2%), Norway (-40.7%), and Belgium (-31.8%) were the laggards during the quarter. From an economic sector standpoint, Health Care, Consumer Staples, and Utilities stocks were areas of strength, while Basic Materials, Energy, and Industrial stocks were detractors from performance. During the third quarter, the U.S. Dollar rose approximately +9.2% vs. Euro and +9.6 vs. the British Pound and was nearly flat vs. the Japanese Yen. We feel the strengthening of the U.S. Dollar reflects investors’ view on risk and the general feeling the slowdown we are seeing in many regions will be worse than many fear.

The table below shows the performance of each EAFE country's national indices broken down between local market return and the USD return during the third quarter of 2008.

Return Attribution for EAFE Countries Third Quarter 2008

Country	Local Return	Curr Return	USD Return	EAFE Weight
Japan	-18.20%	-0.10%	-18.30%	22.10%
United Kingdom	-12.70%	-9.10%	-21.80%	21.70%
France	-9.10%	-9.80%	-18.90%	11.00%
Germany	-10.90%	-9.70%	-20.60%	9.00%
Switzerland	-4.50%	-8.70%	-13.20%	7.90%
Australia	-10.70%	-15.60%	-26.60%	6.30%
Spain	-7.10%	-10.10%	-17.20%	4.30%
Italy	-12.70%	-9.50%	-22.20%	3.70%
Netherlands	-11.50%	-9.60%	-21.10%	2.60%
Sweden	-10.50%	-12.30%	-22.80%	2.10%
Hong Kong	-23.30%	0.40%	-22.90%	2.10%
Finland	-18.40%	-8.90%	-27.30%	1.40%
Singapore	-18.10%	-4.10%	-22.20%	1.20%
Denmark	-17.30%	-9.00%	-26.30%	1.00%
Norway	-31.10%	-9.60%	-40.70%	0.90%
Belgium	-23.50%	-8.30%	-31.80%	0.90%
Greece	-11.80%	-9.60%	-21.40%	0.70%
Austria	-34.10%	-7.10%	-41.20%	0.50%
Ireland	-35.20%	-7.00%	-42.20%	0.40%
Portugal	-8.70%	-9.90%	-18.60%	0.30%
New Zealand	-5.20%	-11.60%	-16.80%	0.10%
EAFE	-13.00%	-7.60%	-20.60%	100.00%

EAFE Country Weights as of Sept. 30, 2008



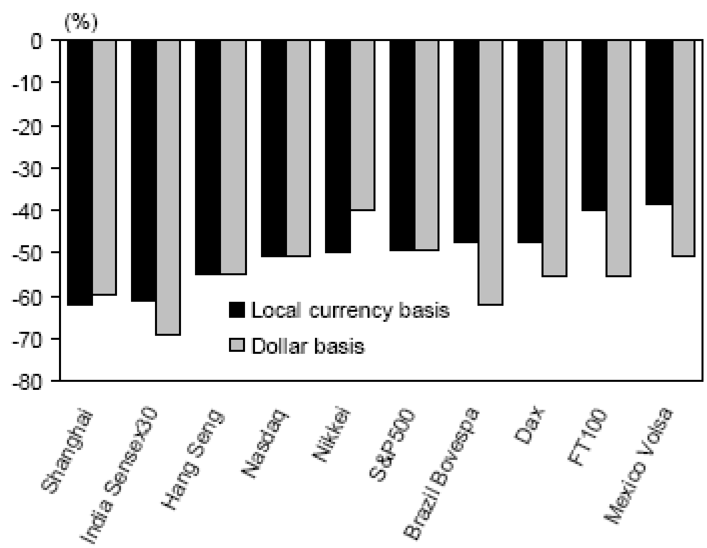
Thus far into the fourth quarter of 2008, the global equity markets have been completely crushed from the likelihood of a rather deep and prolonged recession in the U.S., Japan, and Europe. In addition, major banks and brokerages have been coming under further duress from very volatile credit markets as the central banks around the world continue with coordinated efforts of injecting massive stimulus into the banking system. All signs are pointing to the worst economic downturn in decades. As a result, most major global equity markets are in a major "bear market", with many markets down -50% from the highs of October 2007. Equity market volatility remains at levels never seen before, as daily swings can be quite tremendous. We still expect the central banks to remain active with efforts to lessen the financial crisis over the near term. We expect the equity markets to remain very weak over the balance of 2008 and into 2009 as investors remain very nervous. September thru early December, the MSCI EAFE Index (net dividend) and the S&P 500 Index are down approximately -27.9% and -29.7% respectively. This is the worst performance we have seen in many decades. The U.S. Dollar has continued its key reversal against other major currencies, which has pressured returns further in the fourth quarter. We still feel. Until investors come to ease with the depth and duration of this recession, equity markets will have a difficult time performing well.

Presented below are some charts showing the movement of various currencies:

Japan Update

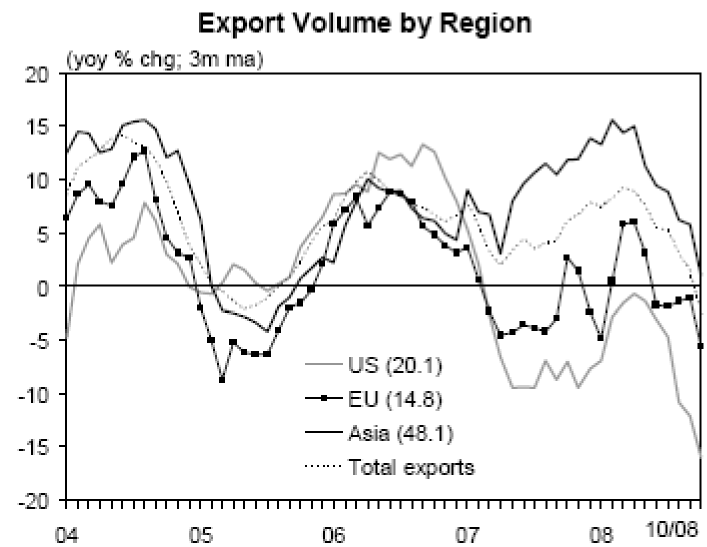
Our recent concerns surrounding Japan's export climate have been well placed. As a result of weakening conditions in the U.S. and in some Asian markets, business conditions have been deteriorating over the course of the third quarter and in the fourth quarter as well. This has certainly been one of the reasons for the weak equity market in Japan. The Nikkei 225 Index was weak throughout the third quarter and recently moved to fresh new lows in late October as the global selloff in equities intensified. However, in the third quarter, the MSCI Japan Index did manage to fair a bit better than in Europe as the Japanese Yen remained relatively flat vs. the U.S. Dollar, which did not detract from performance. We still remain very concerned about business conditions in Japan and realize the global recession will have to show some levels of improvement if we are to see a better equity market in Japan.

Declines in Major Stock Market Indexes: Year to date



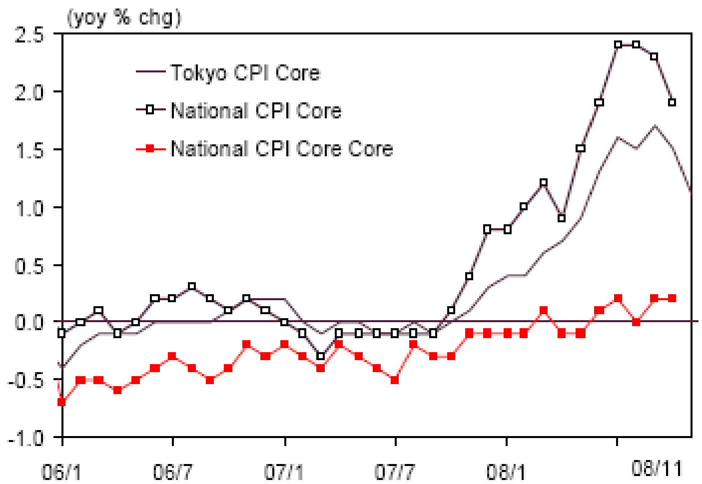
Source: Datastream.

Its official, the Japanese economy is in a recession. GDP shrank -.1% in the third quarter from the previous quarter, or -.4% on an annualized basis. This comes after posting -.7% in the previous quarter. The last time the Japanese economy contracted over two consecutive quarters was in 2001. Growth in Chinese exports has been slowing over the last several months and many believe this helped to push this economy into recession territory. In fact, exports are falling at the fastest pace in several years. Many companies, such as Canon and Toyota, have slashed profit forecasts in anticipation of a bleaker outlook. Production lines are being shutdown and expansion projects are being put on indefinite hold. Recently, industrial production in October fell -3.1% from September, and many feel this is just the beginning. On the consumer front, consumer confidence fell to 29.4 in October, which is a new record low in Japan. In an effort to combat this, approximately $20 billion of stimulus is being directed to the consumer as has been done in the U.S. Also, overnight lending rates have been cut to .3% from .5% in an effort to further stimulate the economy. Consumer prices fell in October as oil and grain prices have fallen from record levels and should keep inflation to a bare minimum over the next few months. Japan's unemployment rate remained in the 4% area during the third quarter, but the jobs-to-applicant ratio was reported at .80, well below 1 as the hiring climate remains difficult at best.



Note: Figures in parenthesis are share of total exports.
Source: MOF.

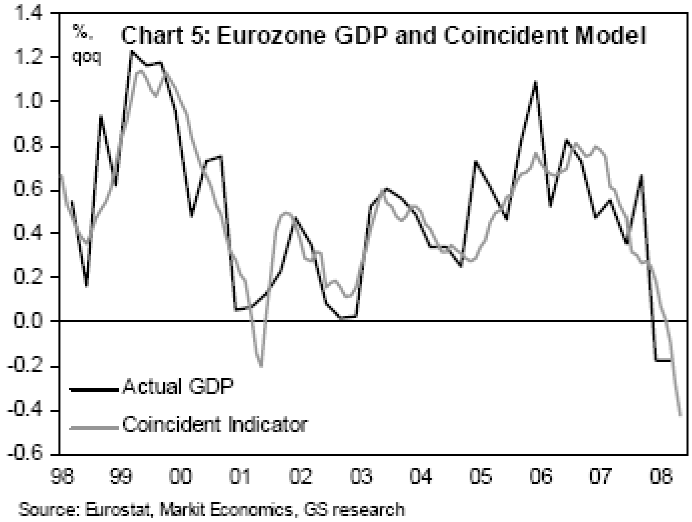
As we look into late 2008 and early 2009, we expect the Japanese economy to remain in a recession. Japan's main trading partners are all weakening relative to just a couple of months ago. While consumers are getting some relief, it certainly won't be enough to bridge the gap from a severely weakening global outlook. Industrial output should continue to shrink over the coming months. We look for official government estimates of GDP to continue to be slashed as fresh data points on the economy are released. Risks clearly remain to the downside. We feel the equity markets could be weak as well, until investors feel more comfortable with the downside that lies ahead in the economy or they begin to see improving business conditions.



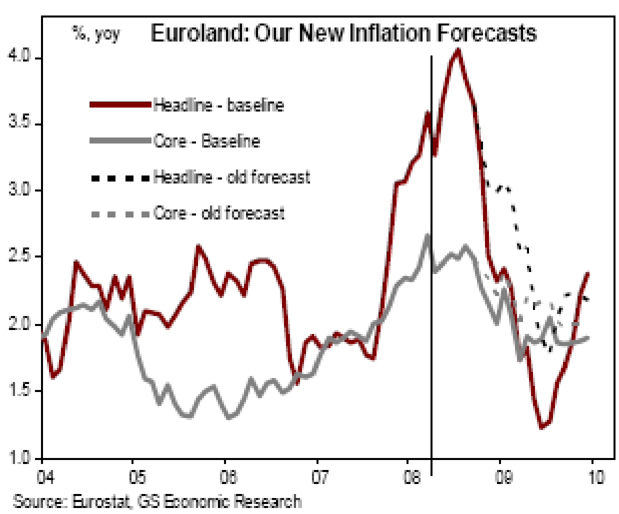
Euroland Update

As has been the case over the last few quarters, equity markets in Euroland continued to be battered by the global slowdown during the third quarter. The MSCI Europe region finished with a -20.8% USD return for the quarter. Financials were pressured by government led bailouts of Fortis Bank and Hypo Real Estate. LIBOR hit record highs and there is a general feeling of little to no confidence where the bottom is at in this situation. Expectations of rising interest rates have been replaced with interest rate cuts by the central banks. What was once an inflation problem has been remedied by falling commodity and energy prices. However, the real concern is how deep will the recession be across Euroland. Business conditions are rapidly deteriorating and households have been more cautious about borrowing and spending as banks tighten lending standards. The ECB has been very active in supporting the credit markets with interest rate cuts and other policy maneuvers in an effort to support the economy and should continue to do so as we enter 2009.

Just as we have seen in Japan, the Euroland economy has entered into an official recession. In the third quarter of 2008, GDP shrank -.2% from the previous quarter. This marks the second straight quarter of negative growth in the Euroland economy and pushed this region into its first recession in 15 years. The cost of credit surged in the third quarter forcing financial institutions to pare back lending to consumers and businesses, much the same as we have seen in other regions around the world. Industrial production declined the most in several years in September as companies shuttered production facilities as demand has fallen off a cliff. An index of executive and consumer sentiment has also dropped to a 15 year low as many expect the economy to take a turn for the worse in the coming months. European retail sales declined in September as consumers cut back spending in anticipation of a deteriorating employment outlook going forward. As we survey these data points, we feel the Euroland economy will continue to weaken over the next couple of quarters until recent stimulus actions take hold down the road in 2009.



As crude oil prices and commodities have come down drastically over the last few months, inflation in Euroland slowed to 2.1% in November from 3.2% in October. This is the largest single drop in over 15 years and puts inflation nearly at the ECB's targeted level. This has given the ECB an opportunity to help the economy and the ECB has responded with interest rate cuts down to 2.50% from 4.25% this morning. Lower interest rates and slowing inflation would provide some measure of relief to consumers and businesses alike.

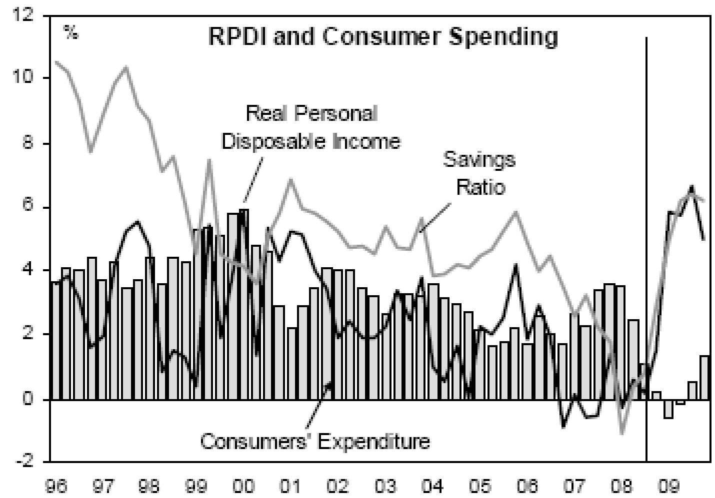


We are beginning to see cracks in the Euroland employment situation. The November unemployment rate rose to 7.7%, from 7.3% in the second quarter. Jobs in the financial services sector are being shed as many firms are near failure and awaiting some type of government sponsored bailout. Also, we hear on a daily basis of manufacturing firms such as Volvo AB, Akzo Nobel NV, Imperial Chemical, and many others that are making plans on cutting workers. We feel we are just on the cusp of many of these announcements to come. In summary, we believe the Euroland economy will experience a fairly deep and rather long recession. How severe it will be is ultimately anybody's guess at this point. We expect the ECB will provide quite a bit of stimulus to the economy in the coming months as this should help to some degree. However, risks appear to lie to the downside over the near term, which should make for weak and choppy financial markets.

Source: Eurostat, Ifo, Markit, Goldman Sachs

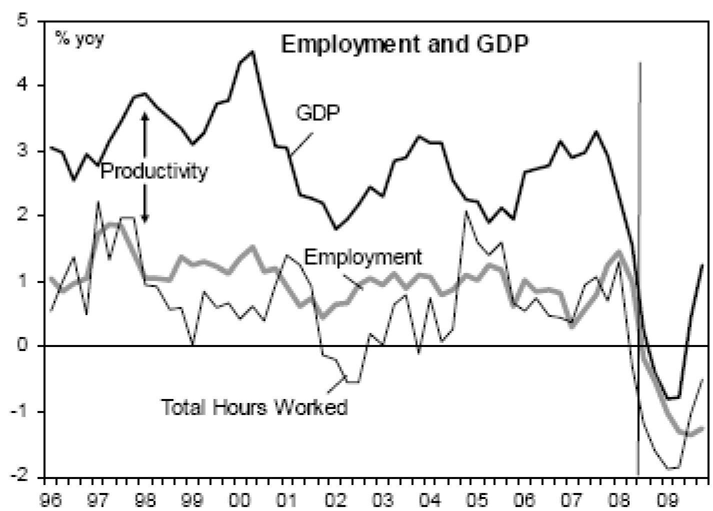
United Kingdom Update

As has been the case in other major regions around the world, the U.K. equity market fell significantly during the third quarter as the financial crisis continued its deadly assault on this region. Credit markets remain frozen and several major financial institutions had to be rescued over the last few months. Needless to say, equity investors remain very nervous and this helped push the U.K. equity market down over -12% on a local currency basis during the quarter. After currency effects, this market finished down over -21% for the quarter. The Bank of England (BOE) was very active in keeping the credit markets functioning with several policy actions during the quarter. The housing and mortgage markets remain in disarray with little improvement seen on the horizon. At this point, we feel it is just a matter of time before this economy finds it way into an official recession.



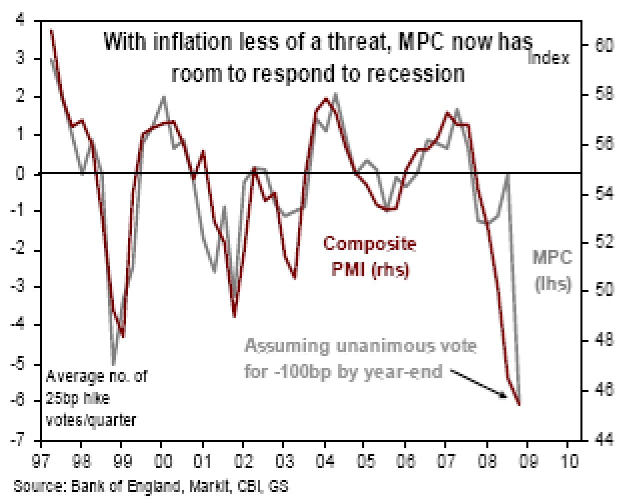
Source: ONS, GS Calculations

The U.K economy contracted for the first time in 16 years during the third quarter as the global slowdown and financial crisis gripped this region. During the third quarter of 2008, the U.K. economy contracted -.5% from the previous quarter, well more than economists had predicted. Things look fairly bleak in this economy at present and growth should contract during the fourth quarter, which would mean a technical recession at that point. Manufacturing production fell for the seventh month in a row in September with little confidence this will change any time soon. Even the Services sector is shrinking at record pace. As banks have curtailed lending, consumer confidence is at the weakest levels in several years even as energy costs have fallen significantly. We expect retail sales to fall off dramatically over the next few months as the consumer looks to curtail any discretionary spending. The housing and mortgage markets remain in a mess as a record low volume of mortgages have been approved and writedowns continue in mammoth proportions.



Source: ONS, GS Calculations

After opting not to cut interest rates at its August and September meetings, the BOE cut interest rates by 50 basis points in a coordinated joint move with the U.S. Fed and the ECB in October in an effort to aid the worst financial crisis in memory. In addition, the government has unveiled an $87 billion bailout package and the BOE is providing loan guarantees to banks in an effort to minimize this crisis. in November, the BOE reduced rates another 150 basis points in one of the largest interest rates cuts by a central bank in recent memory. It also marks the first time the benchmark rate in the U.K. has been below the rate set by the ECB. We feel these are very aggressive actions by the BOE and are in response to just how severe this crisis is. In early December the BOE slashed rates again 100 basis points to 2%. On the employment front, the U.K. unemployment rate continues to rise and stood at 5.8% in September, the highest level in years. We expect this trend to continue until we see the economy bottom out. There are now over 980,000 claimants receiving some form of jobless benefits, which is near an eight year high. As for the U.K. equity market, we expect to see a market that will probably remain weak over the balance of the year as investors' fear just how deep this recession will be and how much corporate earnings will have to be cut. Until we see some clarity on these fronts, equity markets should remain quite volatile.



International Equity Activity/Strategy

At this point, it certainly feels we are in the worst financial crisis in over a generation and perhaps since the Great Depression. Only time will tell. What is certain is most major regions around the world are in recessionary territory. Even emerging markets, which have been a pillar of strength over the last several years, are now slowing down to levels we have not seen in a while. Global economic indicators continue to weaken almost on a daily basis. We hear daily news of fresh employment cutbacks as company after company is being forced to shed employees as business dries up.

As a result, consumer confidence readings continue to weaken. Housing markets around the globe remain well into an oversupply situation which will take some time to correct back to normalized levels. It is imperative the global financial system get healthy once again in order to foster growth. However, a few of our recent concerns have moved in a positive direction. Crude oil prices have fallen from the $120 a barrel level down to the $50 level. This is providing much needed relief for the consumer. Also, commodity costs have fallen off quite drastically, which should help input costs with many companies and help offset the sharp downward pressure on revenues. Inflation fears have all but gone away in the near term and many feel a potentially dangerous deflation scenario could be developing. We will remain watchful of this situation over the next few quarters. Overall, with regard to the global equity markets, valuations are at levels we have not seen in many years. However, we feel this in itself is probably not enough to declare an end to the current bear market. We need to see an environment where we can see a better business climate emerging coupled with a more realistic view on corporate earnings in order to get more positive on equities. Thus far, we have not seen this. Therefore, we feel the equity markets will remain weak over the balance of 2008.

We have not made any incremental investments into or out of our international equity portfolio since our last update. We still remain moderately underweight large-cap international equities and well underweight emerging market equities relative to our peers. Obviously, with the credit market turmoil we have witnessed over the last few months, we have curtailed much of the evaluation of any structured note equity or overlay product which would require us to take on credit risk. As always, we will remain watchful for any developments which would provide us a favorable risk/reward opportunity in the present environment. Our total allocation to international equities is approximately 12.5% of total TRS and ERS assets and 7.2% of the JRF total assets. Therefore, we expect to remain near these levels over the near term. *(Charts provided by Factset, Bloomberg, Datastream, Bank of England, Goldman Sachs, Markit, Ifo, CBI, ECB, ONS, Eurostat, MOF, MIC, Cabinet Office, BOJ)*

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING October 31, 2008

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
TRS CORE FUND	1,275,506,044	-15.58	-22.98	-32.17	-15.58	-35.39	-4.44	0.53	0.53	Oct-94
TRS GOLDMAN SACHS GROUP INC	154,525,500	-17.08	-23.18	-28.96	-17.08	-29.16				Aug-06
TRS CREDIT SUISSE	124,012,000	-16.65	-22.64		-16.65					Apr-08
TRS S&P 500 FUND	3,415,316,728	-16.79	-22.98	-32.70	-16.79	-35.96	-5.11	0.39	0.50	Oct-94
TRS S&P MID CAP INDEX	577,244,473	-21.79	-28.87	-32.92	-21.79	-36.34	-5.49	1.98	6.84	Oct-94
TRS S&P SMALL CAP INDEX	312,484,800	-20.01	-22.19	-25.93	-20.01	-31.99	-4.16	3.45		Mar-01
TRS SMALLCAP ACTIVE FUND	57,484,865	-20.15	-24.47	-26.71	-20.15	-32.72				Jun-06
TRS SPECIAL SITUATIONS	313,808,352	-19.72	-28.33	-32.12	-19.72	-37.77	-5.64	1.85	4.01	Oct-94
TRS TOTAL DOMESTIC EQUITY	6,230,382,762	-17.39	-23.93	-32.16	-17.39	-35.51	-4.97	0.85	1.44	Oct-91
TRS CUSTOM DOMESTIC EQUITY INDEX		-17.74	-23.95	-32.51	-17.74	-35.94	-5.20	0.71		
S&P 500		-16.80	-23.11	-32.84	-16.80	-36.10	-5.21	0.26	0.40	
S&P 400 MIDCAP		-21.74	-28.93	-32.97	-21.74	-36.46	-5.52	1.96	6.71	
S&P 600 SMALL CAP		-20.15	-22.43	-26.44	-20.15	-32.44	-4.36	3.33	7.11	
INTERNATIONAL EQUITY										
TRS ALLEGRO INVESTMENT CORP SA	65,469,649	0.92	1.79	8.59	0.92	8.91				Mar-07
TRS MORGAN STANLEY PLUS NOTES MSCI	43,049,510	-19.51	-35.93	-34.22	-19.51	-33.24				Mar-07
TRS MERRILL LYNCH INTERNATIONAL	23,290,560	-23.26	-35.60	-32.96	-23.26	-34.30				Aug-07
TRS INTERNATIONAL EQUITIES	1,884,953,698	-20.01	-34.27	-43.07	-20.01	-46.12	-4.83	4.02	2.26	Nov-94
TRS TOTAL INTERNATIONAL EQUITY	2,016,763,417	-19.50	-33.52	-41.78	-19.50	-44.74	-3.99	4.57	2.52	Oct-94
MSCI EAFE (NET)		-20.18	-34.49	-43.54	-20.18	-46.62	-5.26	3.60	1.67	
TRS TOTAL GLOBAL EQUITY	8,247,146,179	-17.92	-26.53	-34.80	-17.92	-38.04	-4.75	1.63	2.56	Oct-75

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING October 31, 2008

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TRS CUSTOM GLOBAL EQUITY INDEX		-18.34	-26.82	-35.59	-18.34	-38.92	-5.26	1.28		
FIXED INCOME										
TRS DOMESTIC FIXED INCOME	2,482,812,607	-3.08	-5.31	-4.44	-3.08	-2.52	2.95	4.05		Aug-99
TRS CUSTOM DOMESTIC FIXED INDEX		-3.56	-6.59	-6.43	-3.56	-4.80	1.75	2.39		
TRS TOTAL FIXED (ex. Private Placements)	2,482,812,607	-3.08	-5.31	-4.44	-3.08	-2.52	2.97	4.06		Oct-03
TRS CUSTOM GLOBAL FIXED INDEX		-3.56	-6.59	-6.43	-3.56	-4.80	1.74	2.39		
TRS PRIVATE PLACEMENTS	2,744,722,729	1.43	-5.03	-5.32	1.43	-4.24	9.30	8.03		Aug-99
TRS CASH ACCOUNT	94,523,824	0.18	0.60	2.37	0.18	3.18	4.70	3.61		Sep-03
TRS TOTAL FIXED INCOME	5,322,059,159	-0.73	-5.09	-4.72	-0.73	-3.26	6.08	5.90	5.94	Oct-93
ALTERNATIVE INVESTMENTS										
TRS PREFERRED STOCK	611,550,850	-0.02	-26.53	-27.37	-0.02	-27.63	-1.04	-5.61		Sep-03
TRS REAL ESTATE	1,501,771,269	0.00	2.34	3.08	0.00	3.08	4.04	5.27		Oct-03
TRS INTERNALLY MANAGED	332,782,794	0.50	1.08	3.14	0.50	4.05	4.98	3.89		Oct-03
TRS TOTAL ALTERNATIVES	2,446,104,913	0.08	-7.03	-6.47	0.08	-6.33	1.84	1.50		Oct-03
TRS TOTAL F.I. PLUS ALTERNATIVES	7,768,164,073	-0.47	-5.66	-5.24	-0.47	-4.20	4.79	4.68	5.29	Oct-93

TEACHERS RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING October 31, 2008

STATE STREET.

RATES OF RETURN - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
TRS TOTAL PLAN POLICY		-12.52	-18.86	-25.54	-12.52	-28.13	-2.78	1.68		
TRS TOTAL PLAN	16,015,310,252	-10.24	-17.64	-23.16	-10.24	-25.26	-0.58	2.96	4.07	Oct-88

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING October 31, 2008

STATE STREET

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
ERS CORE FUND	686,769,473	-15.60	-23.00	-32.19	-15.60	-35.38	-4.37	0.53	0.50	Oct-94
ERS GOLDMAN SACHS GROUP INC	69,424,500	-17.08	-23.18	-28.96	-17.08	-29.16				Aug-06
ERS CREDIT SUISSE	56,238,000	-16.65	-22.64		-16.65					Apr-08
ERS S&P 500 FUND	1,551,614,900	-16.79	-22.98	-32.71	-16.79	-35.96	-5.11	0.44	0.53	Oct-94
ERS S&P MID CAP INDEX	255,077,765	-21.80	-28.88	-32.91	-21.80	-36.30	-5.48	2.00	6.88	Oct-94
ERS S&P SMALL CAP INDEX	128,512,000	-20.01	-22.19	-25.93	-20.01	-31.99	-4.16	3.44		Mar-01
ERS SMALLCAP ACTIVE FUND	28,346,377	-20.13	-24.48	-26.73	-20.13	-32.74				Jun-06
ERS SPECIAL SITUATIONS	168,873,026	-19.70	-28.32	-32.06	-19.70	-37.70	-5.49	1.97	4.00	Oct-94
ERS TOTAL DOMESTIC EQUITY	2,944,856,042	-17.33	-23.94	-32.18	-17.33	-35.53	-4.95	0.87	1.48	Oct-93
ERS CUSTOM DOMESTIC EQUITY INDEX		-17.72	-23.96	-32.54	-17.72	-35.96	-5.21	0.69		
S&P 500		-16.80	-23.11	-32.84	-16.80	-36.10	-5.21	0.26	0.40	
S&P 400 MIDCAP		-21.74	-28.93	-32.97	-21.74	-36.46	-5.52	1.96	6.71	
S&P 600 SMALL CAP		-20.15	-22.43	-26.44	-20.15	-32.44	-4.36	3.33	7.11	
INTERNATIONAL EQUITY										
ERS ALLEGRO INVESTMENT CORP SA	31,269,110	0.92	1.79	8.59	0.92	8.91				Mar-07
ERS MORGAN STANLEY PLUS NOTES MSCI	20,560,960	-19.51	-35.93	-34.22	-19.51	-33.24				Mar-07
ERS MERRILL LYNCH INTERNATIONAL	12,555,068	-23.26	-35.60	-32.96	-23.26	-34.30				Aug-07
ERS INTERNATIONAL EQUITIES	828,768,387	-20.01	-34.27	-43.06	-20.01	-46.15	-4.86	3.98	2.27	Nov-94
ERS TOTAL INTERNATIONAL EQUITY	893,153,525	-19.46	-33.46	-41.66	-19.46	-44.64	-3.95	4.58	2.56	Oct-94
MSCI EAFE (NET)		-20.18	-34.49	-43.54	-20.18	-46.62	-5.26	3.60	1.67	
ERS TOTAL GLOBAL EQUITY	3,838,009,567	-17.84	-26.39	-34.66	-17.84	-37.91	-4.74	1.64	2.55	Oct-93

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
ERS CUSTOM GLOBAL EQUITY INDEX		-18.31	-26.69	-35.45	-18.31	-38.79	-5.25	1.27		
FIXED INCOME										
ERS DOMESTIC FIXED INCOME	1,134,057,953	-3.08	-5.37	-4.48	-3.08	-2.53	3.00	4.09		Sep-99
ERS CUSTOM DOMESTIC FIXED INDEX		-3.58	-6.64	-6.47	-3.58	-4.84	1.75	2.38		
ERS TOTAL FIXED (ex. Private Placements)	1,134,057,953	-3.08	-5.37	-4.48	-3.08	-2.53	3.02	4.10		Oct-03
ERS CUSTOM GLOBAL FIXED INDEX		-3.58	-6.64	-6.47	-3.58	-4.84	1.74	2.38		
ERS PRIVATE PLACEMENTS	1,343,678,387	1.47	-5.02	-5.38	1.47	-4.33	9.38	7.87		Aug-99
ERS CASH ACCOUNT	45,040,571	0.18	0.60	2.36	0.18	3.17	4.79			Sep-03
ERS TOTAL FIXED INCOME	2,522,776,911	-0.63	-5.10	-4.77	-0.63	-3.33	6.22	5.91	5.89	Oct-93
ALTERNATIVE INVESTMENTS										
ERS PREFERRED STOCK	511,091,905	-0.01	-21.17	-21.32	-0.01	-21.47	1.54	-1.62		Sep-03
ERS REAL ESTATE	729,895,560	0.00	2.33	3.03	0.00	3.03	4.15	5.24		Oct-03
ERS INTERNALLY MANAGED	160,250,898	0.49	1.07	3.11	0.49	4.02	4.97	3.88		Oct-03
ERS TOTAL ALTERNATIVES	1,401,238,363	0.04	-7.61	-7.14	0.04	-7.03	2.38	1.85		Oct-03
ERS TOTAL F.I. PLUS ALTERNATIVES	3,924,015,274	-0.40	-5.93	-5.58	-0.40	-4.61	4.93	4.68	5.23	Oct-93

EMPLOYEE RETIREMENT OF ALABAMA

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING October 31, 2008

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
ERS TOTAL PLAN POLICY		-12.38	-18.62	-25.30	-12.38	-27.87	-2.81	1.59		
ERS TOTAL PLAN	7,762,024,841	-9.84	-17.30	-22.71	-9.84	-24.76	-0.41	2.93	3.93	Oct-93

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

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PERIODS ENDING October 31, 2008

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
U.S. EQUITY										
JRF S&P 500 FUND	87,880,281	-16.79	-23.02	-32.73	-16.79	-35.98	-5.06	0.39	0.51	Oct-94
JRF S&P MID CAP INDEX	7,630,660	-21.79	-28.89	-33.21	-21.79	-36.60	-5.55	1.95	6.87	Oct-94
JRF S&P SMALL CAP INDEX	2,814,400	-20.01	-22.19	-25.93	-20.01	-32.00	-4.17	3.64		Mar-01
JRF TOTAL DOMESTIC EQUITY	98,325,342	-17.30	-23.49	-32.58	-17.30	-35.91	-5.05	0.62	1.05	Oct-93
JRS CUSTOM DOMESTIC EQUITY INDEX		-17.30	-23.59	-32.68	-17.30	-36.02	-5.20	0.49		
S&P 500		-16.80	-23.11	-32.84	-16.80	-36.10	-5.21	0.26	0.40	
S&P 400 MIDCAP		-21.74	-28.93	-32.97	-21.74	-36.46	-5.52	1.96	6.71	
S&P 600 SMALL CAP		-20.15	-22.43	-26.44	-20.15	-32.44	-4.36	3.33	7.11	
INTERNATIONAL EQUITY										
JRF ALLEGRO INVESTMENT CORP SA	977,156	0.92	1.79	8.59	0.92	8.91				Mar-07
JRF MORGAN STANLEY PLUS NOTES MSCI	642,530	-19.51	-35.93	-34.22	-19.51	-33.24				Mar-07
JRF MERRILL LYNCH INTERNATIONAL	545,873	-23.26	-35.60	-32.96	-23.26	-34.30				Aug-07
JRF INTERNATIONAL EQUITIES	11,484,982	-19.99	-34.26	-43.05	-19.99	-46.11				Nov-06
JRF TOTAL INTERNATIONAL EQUITY	13,650,541	-18.90	-32.61	-40.03	-18.90	-42.83				Nov-06
MSCI EAFE (NET)		-20.18	-34.49	-43.54	-20.18	-46.62	-5.26	3.60	1.67	
JRF TOTAL GLOBAL EQUITY	111,975,882	-17.50	-24.74	-33.59	-17.50	-36.85	-5.16	0.56	1.02	Oct-93
DOMESTIC FIXED INCOME										
JRF DOMESTIC FIXED INCOME	54,148,704	-3.46	-5.82	-5.50	-3.46	-3.72	2.82	3.49	3.42	Oct-93
JRF CUSTOM DOMESTIC FIXED INDEX		-3.71	-6.97	-6.83	-3.71	-5.15	1.65	2.30		

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING October 31, 2008

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
JRF PRIVATE PLACEMENTS	6,935,630	-0.82	-13.86	-17.53	-0.82	-17.98	5.79	7.18		Oct-01
JRF CASH ACCOUNT	5,405,868	0.18	0.60	2.37	0.18	3.19	4.47	3.47		Sep-03
JRF TOTAL FIXED INCOME	66,490,202	-2.83	-6.16	-6.33	-2.83	-4.95	3.59	4.32	4.07	Oct-93
ALTERNATIVE INVESTMENTS										
JRF REAL ESTATE	2,646,744	0.00	4.71	6.20	0.00	6.20	5.32	5.89		Oct-03
JRF INTERNALLY MANAGED CASH	12,680,669	0.43	0.99	3.11	0.43	4.04	4.88	4.03		Oct-03
JRF TOTAL ALTERNATIVES	15,327,413	0.37	1.48	3.53	0.37	4.32	4.91	5.44		Oct-03
JRF TOTAL F.I. PLUS ALTERNATIVES	81,817,616	-2.14	-4.53	-4.15	-2.14	-2.89	4.02	4.52	4.17	Oct-93

JUDICIAL RETIREMENT FUND

SUMMARY OF PERFORMANCE

RATES OF RETURN

PERIODS ENDING October 31, 2008

STATE STREET.

SUMMARY OF PERFORMANCE - GROSS OF FEE

	MKT VALUE	1 Month	3 Month	CYTD	FYTD	1 Year	3 Years	5 Years	10 YEARS	Fund Inception date
TOTAL PLAN										
JRF TOTAL PLAN	193,793,498	-11.58	-17.27	-23.49	-11.58	-25.62	-1.60	2.16	2.80	Oct-93
JRF TOTAL PLAN POLICY		-13.03	-19.21	-26.10	-13.03	-28.43	-3.38	0.59		